BUSINESS NZ

PLANNING FORECAST

DECEMBER 2014

BusinessNZ

NZ Economy – cautious optimism

Executive Summary

The NZ economy is in relatively strong heart, at least compared with some key international economies.

While there has been a focus on reduced commodity prices and the threat of deflation internationally, key economic indicators point to relatively strong growth over the forecast period.

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show significant growth in both these key sectors, while other sectors, particularly construction, also show significant activity. The second National Construction Pipeline report confirms that building and construction activity in NZ is expected to reach unprecedented levels by 2017 – around $100 billion over the next three years.

While the agricultural sector is going through a period of readjustment, particularly in relation to reduced international dairy prices, the sector is certainly not all doom and gloom. Yes the forecast dairy payout for 2014/15 has continued to decline (currently forecast at $4.70 per kg) but this needs to be put in the context of an extremely high payout for 2013/14 and other one off (perfect storm) factors currently impacting on demand, for example, the Russian trade ban, other countries' (and NZ's) expanding production in light of record prices earlier this year and the slow-down in imports from China. The longer-term outlook is still relatively positive as Asia's demand for protein continues apace.

Business and consumer confidence took a hit from the dizzy heights of earlier this year but recent surveys are now suggesting some consolidation and expansion. Certainly, investment intentions are improving while employment growth is expanding significantly according to both quantitative and qualitative surveys.

The previous threat of inflationary pressures as a result of strong net inward migration and supply side issues associated with construction costs, seems to have abated somewhat, and general inflationary pressures are under firm restraint, helped in part by a still elevated currency and declines in the price of oil on international markets.

Consumer confidence appears to be on the increase assisted by a relatively strong employment growth outlook and relatively low interest rates, likely to remain low for a significant period of time. Given household debt remains at high levels, interest rate stability will give households some confidence that their real disposable incomes will remain in positive territory.

The Treasury released the Half-year Economic and Fiscal Update (HYEFU) on the 16th December. The previous update, forecasting a wafer-thin surplus for 2015, now forecasts a deficit of $572 million, the economy having come under some pressure due principally to a lower than previously-projected tax take. Economic growth figures have been reduced for the forecast period but are still reasonably solid, particularly given the hit taken over commodity prices. Overall the HYEFU shows an economy with a reasonably optimistic outlook for the period to 2018.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 11 for the December 2014 quarter, up 8 on the previous quarter and down 7 on a year ago.

The NZ economy is in relatively strong heart, at least compared with some key international economies.

Growth is certainly not spread evenly across NZ. Feedback from BusinessNZ's Affiliated Industries Group (AIG) indicates that growth across the various sectors, and even within sectors and regions, is still quite mixed.

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show significant growth in both these key sectors, while other sectors, particularly construction, are also showing significant activity.

While the agricultural sector is going through a period of readjustment, particularly in relation to reduced international dairy prices, the sector is certainly not all doom and gloom. A number of events which could be described as a perfect storm have acted to reduce dairy prices over 2014. The longer term outlook is sounder, although a number of international risks remain.

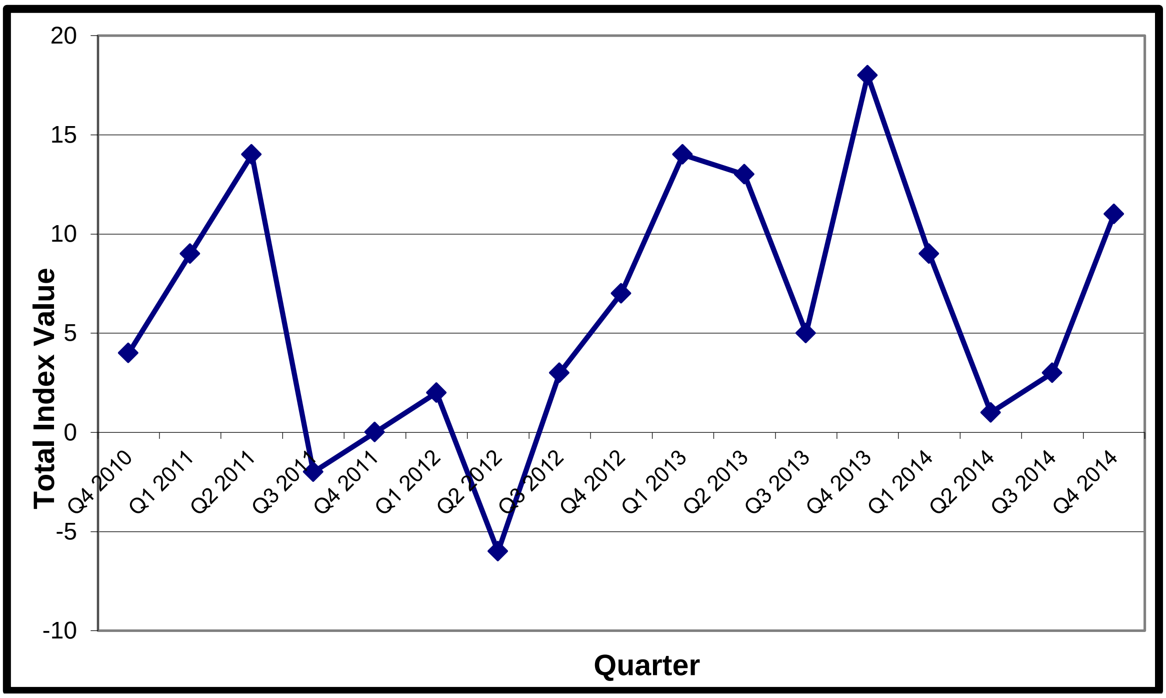
Business and consumer confidence took a hit from the dizzy heights of earlier this year but recent surveys are now suggesting some consolidation and expansion. Certainly, investment intentions are improving while employment growth is expanding significantly according both to quantitative and qualitative surveys. Inflationary expectations remain relatively benign.

PART 1: THE NEW ZEALAND ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of the major economic indicators) sits at 11 for the December 2014 quarter, up 8 on the previous quarter and down 7 on a year ago.[1] Drops in commodity prices and perhaps an element of pre-election business and consumer confidence jitters, together with interest rate rises starting to kick in, were likely largely responsible for the dip in the index mid-2014. Since then, confidence has consolidated somewhat with improving labour market conditions boosting the index.

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Of the ECI sub-groups:

<u>Economic growth/performance indicators</u> sit at 1 for the December 2014 quarter, the same as for the last quarter and down 2 on a year ago. Significant reductions in commodity prices, particularly dairy, are being reflected in NZ terms of trade. This has not been helped by a stubbornly high $NZ.

<u>Monetary policy/pricing indicators</u> sit at 1 for the December 2014 quarter, up 5 on the last quarter and down 1 on a year ago. Further interest rate rises are now firmly on hold for the foreseeable future as inflationary pressures remain relatively benign – assisted by both falling international commodity prices and a relatively high $NZ.

<u>Business/consumer confidence indicators</u> sit at 3 for the December 2014 quarter, up 4 on the previous quarter but down 3 on a year ago. Business and consumer confidence took a hit mid-year on the back of higher

[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case. For example, declines in unemployment are seen as positive and increases as negative.

interest rates, significant declines in commodity prices and significant uncertainty about the outcome of the general election. Since that time confidence has consolidated and remains firmly in positive territory.

Labour market indicators sit at 6 for the September 2014 quarter, down one on the previous quarter and down 1 on a year ago. Both the BNZ-BusinessNZ Performance of Manufacturing (PMI) and Performance of Services (PSI) Indexes show relatively strong employment growth. This is reinforced by a number of quantitative and qualitative surveys.

PART 2: THE NEW ZEALAND ECONOMY – WHERE ARE WE GOING?

1.1 Economic growth (GDP) – solid but not spectacular

NZ's growth prospects need to be looked at in the context of global world growth. While forecast growth of around 3 percent per annum out to December 2016 (see below) might not seem spectacular, New Zealand, by international comparisons, is doing pretty well.

Forecasts: Real GDP % Growth

	Years Ending		
	Dec 14	Dec 15	Dec 16
Highest	3.6	3.3	2.9
Average	3.4	3.2	2.6
Lowest	3.1	3.0	1.8

Source: ANZ, ASB, BNZ, and Westpac

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show activity/sales continuing to remain at elevated levels.

Other sectors, particularly construction, show significant continuing activity, not surprising given the ongoing rebuild of Christchurch and a pent-up demand for housing, particularly in Auckland. The second National Construction Pipeline report confirms that building and construction activity in NZ is expected to reach unprecedented levels by 2017 – around $100 billion over the next three years! This is massive given that the entire NZ economy rates at only slightly over $200 billion per annum.

On the other hand, the agricultural sector is going through a period of readjustment. The forecast dairy payout for 2014/15 has continued to decline (currently forecast at $4.70 per kg) but this needs to be put in the context of an extremely high payout for 2013/14 and other one off (perfect storm) factors currently impacting on demand, for example, the Russian trade ban, other countries (and NZ's) expanding production in light of record prices earlier this year and the slow-down in imports from China. The longer-term outlook is still relatively positive as Asia's demand for protein continues apace.

Business and consumer confidence took a hit from the dizzy heights of earlier this year but recent surveys suggest some consolidation and expansion of confidence. Certainly, investment intentions are improving while employment growth is expanding significantly according both to quantitative and qualitative surveys.

Given NZ's distance from markets, it might be assumed that the country is insulated from what is happening in the rest of the world but this could not be further from the truth.

There are a number of international risks that could impact on NZ's continued economic fortunes. These include, in no particular order of importance:

- World demand – most developed countries are still in a slow recovery phase, while NZ's major trading partner, China, has come off the boil of late
- The continuation of the Russian trade ban
- Europe and the US having to find other places to send production (particularly dairy)
- The ebola outbreak and possible containment
- Middle East extremist factions
- Potential international deflation and impacts on incentives to invest
- The process of moving towards more sustainable monetary policy regimes in key international markets (particularly the US and Europe)
- Australia's continued economic malaise

Domestically, risks include:

- A continuing elevated $NZ (particularly for exporting firms)
- High levels of both household and agricultural debt increasing vulnerability to any interest rate hikes
- Who wins the inflation battle between rising house prices on the back of strong domestic demand and falling commodity prices (notably dairy and oil)
- The potential impact of uneven growth throughout NZ. Feedback from BusinessNZ's Affiliated Industries Group (AIG) indicates that growth across the various sectors, and even within sectors and regions, is still quite mixed
- Risk of government 'third term itis' and whether the current Government can ensure regulatory reform provides a catalyst for business to feel confident to invest in NZ without ongoing roadblocks being put in the way of future development

These are all very important issues which make forecasting particularly difficult. In fact, the only certainty is that uncertainty is likely to reign for the foreseeable future.

An excellent quote from Tony Alexander, Chief Economist, BNZ in the BNZ Weekly Overview (27th November 2015) ably sums up the world we live in:

"In this new world you must not develop a strategic plan highly dependent upon someone's forecasts proving correct. You need to emphasise flexibility in your hiring and remuneration practices, stocking levels, property leases and so on. As an investor be wary of companies without such flexibility and perhaps with boards made up of staid individuals wedded to "The Plan""

1.2 Monetary Conditions – on hold indefinitely

Interest rates – on hold

The 90-day bill rate is forecast to increase slightly over the forecast period to reach 4.6 percent by December 2016 (see forecasts below).

Forecasts: Interest Rates (90 day bills)

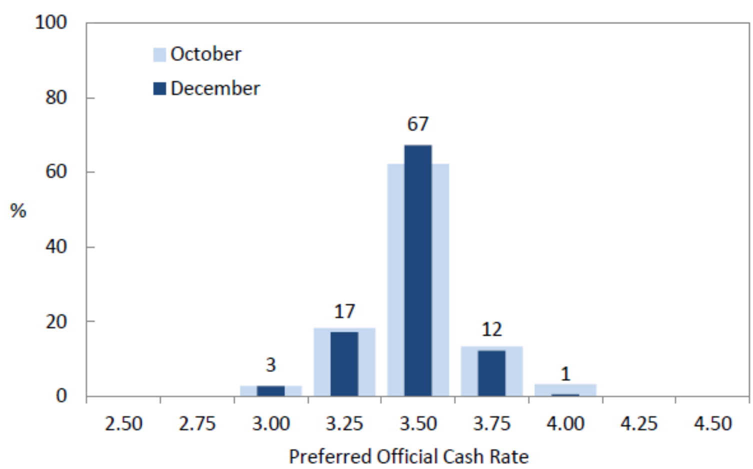
	As at end of		
	Dec 14	Dec 15	Dec 16
Highest	3.8	4.3	4.9
Average	3.7	4.2	4.6
Lowest	3.7	4.0	4.2

Source: ANZ, ASB, BNZ, and Westpac

Essentially, the Reserve Bank has come out in its latest Official Cash Rate (OCR) review (12th December 2015) as implying the OCR is likely to remain at current levels (3.5 percent) for an extended period of time.

The Reserve Banks's decision to put future interest rate rises on hold is strongly supported by the New Zealand Institute of Economic Research's (NZIER) Shadow Monetary Policy Board (which has the task of recommending interest rate settings ahead of each decision by the Governor of the Reserve Bank).

***NZIER Shadow Board* recommends leaving interest rates where they are**



Source: NZIER *Monetary Policy Shadow Board*

In their pre-Reserve Bank announcement on Tuesday 10th December, most Shadow Monetary Policy Board members were in favour of keeping interest rates at current levels for now. 67 percent of votes supported the OCR remaining at its current position of 3.5 percent, 20 percent supported a reduction in the OCR, and 13 percent supported an increase.

"Global growth is declining, commodity prices are falling and domestic inflation is muted" said Dr Kirdan Lees, Principal Economist at NZIER. "Credit growth is in check so there are few reasons to raise rates right now."

The New Zealand dollar – drifting lower

Forecasts show the NZ dollar as generally expected to drift lower against both the Australian and US dollars but predicting the future direction of the NZ dollar is fraught with difficulty, depending on what assumptions are built into models, as the widespread differences below indicate.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 14	Dec 15	Dec 16
Highest	0.916	0.897	0.880
Average	0.898	0.877	0.851
Lowest	0.880	0.850	0.820

USD (cents)			
	Dec 14	Dec 15	Dec 16
Highest	0.790	0.800	0.790
Average	0.775	0.738	0.710
Lowest	0.760	0.700	0.660

TWI			
	Dec 14	Dec 15	Dec 16
Highest	78.2	77.2	75.7
Average	76.8	74.3	71.8
Lowest	76.2	70.6	67.6

Source: ANZ, ASB, BNZ, and Westpac

Forecasting exchange rates has not been helped by a significant move away from traditional monetary policy settings towards expansionary mechanisms such as quantitative easing and the like. With international interest rates at close to zero and a real threat of deflation on the global scene, uncertainty is likely to prevail for some time.

Inflation – on balance benign

Forecasts outlined below show inflation likely to rise slightly over the forecast period to reach 2.4 percent by December 2016. This is still well within the Reserve Bank's target range of 1-3 percent.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Dec 14	Dec 15	Dec 16
Highest	1.0	2.2	2.6
Average	0.9	1.8	2.4
Lowest	0.8	1.3	2.2

Source: ANZ, ASB, BNZ, and Westpac

Inflationary pressures appear to be well under control with the risks of inflation, for the moment at least, on the downside.

On the one hand, some upward pressure is occurring as a result of house price rises and relatively strong domestic demand although wage pressures from a significantly improved labour market have yet to have any material impact. But holding the upper hand is downward inflationary pressure, the product of reduced international commodity prices (mainly dairy and oil), a still elevated $NZ taking the heat out of any tradeables' inflationary pressures, the threat of deflation internationally and relatively subdued credit growth.

1.3 Business and consumer confidence – consolidating after earlier falls

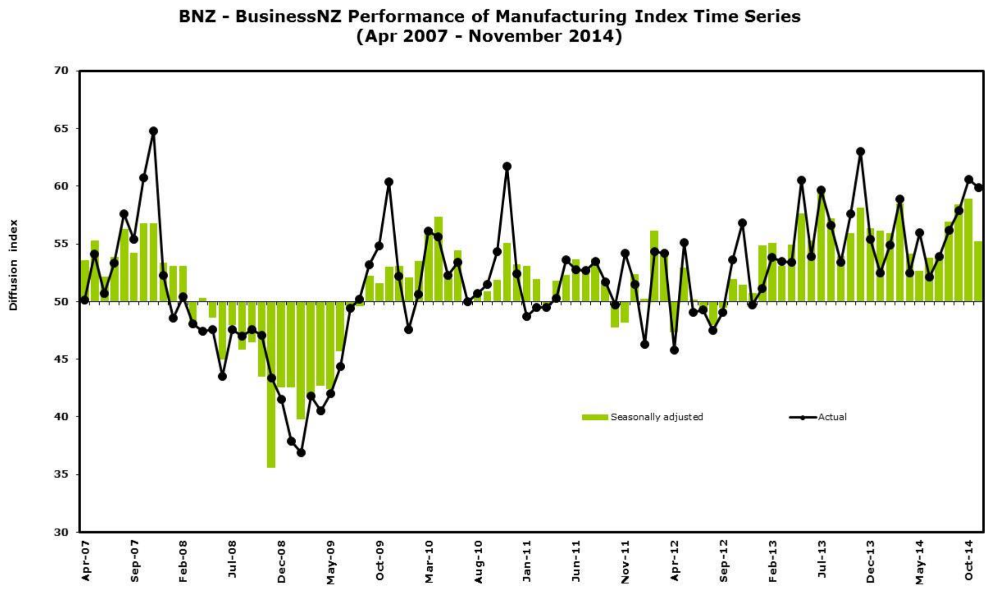
Business confidence – improving again

While business confidence trended down from an historic high for most of 2014, over recent months a number of surveys have shown signs of confidence consolidating at reasonable levels. Obviously the continued drop in commodity prices made a dent in the agricultural sector but other sectors have gone from strength to strength. The earlier drop in confidence probably also reflected uncertainty about the outcome of the general election in September (now done and dusted) and also the impact of earlier interest rate hikes. Most of these influences have since abated somewhat and businesses are now firmly back in investment mode. Sharemarket results post-election are also testament to improved confidence across the board.

The BNZ-BusinessNZ Performance of Manufacturing (PMI) and Performance of Services (PSI) continue to show relatively strong growth in both major sectors of the NZ economy. Perhaps even more importantly, both surveys point to relatively strong employment growth.

The BNZ-BusinessNZ seasonally adjusted PMI for November 2014 stood at 55.2, 3.7 points lower than the previous month, although still showing solid expansion. The PMI has averaged 55.9 so far for 2014, while the sector has now been in expansion for 26 consecutive months.

Despite a dip in levels, all five seasonally adjusted diffusion indices were again in expansion during November. *Production* and *deliveries* (both 56.6) led the way, with the former slipping 5.3 points from the previous month. *New orders* (55.1) decreased in expansion levels compared to the previous two post-60 point values for September/October, while *employment* (54.9) fell back from its record value in October. *Finished stocks* (51.4) remained relatively unchanged from the previous month.

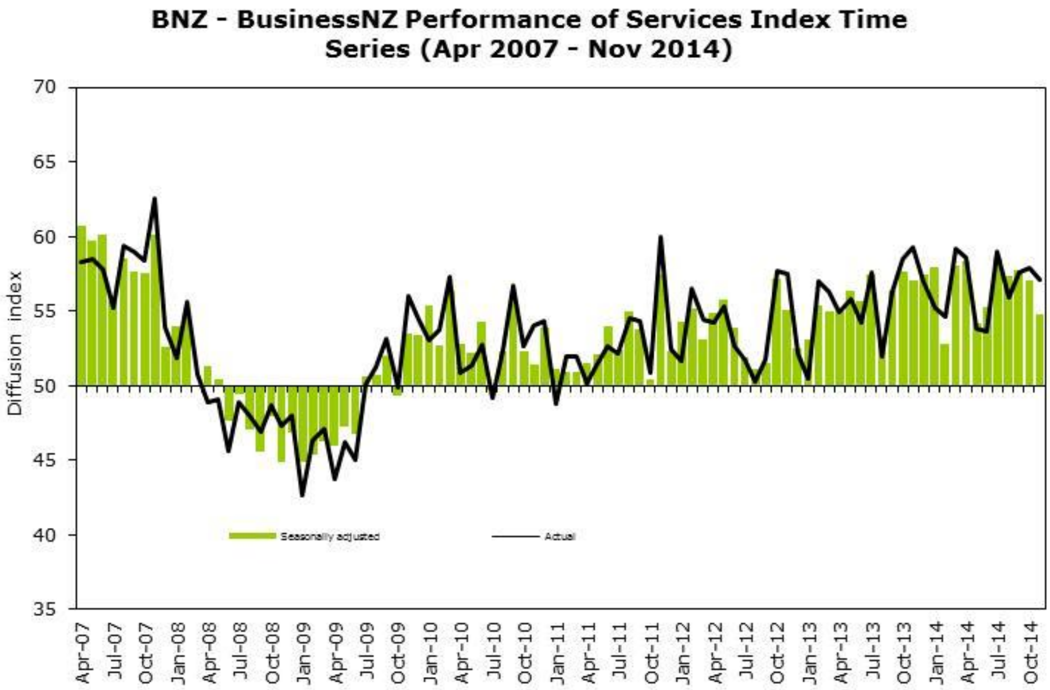


All four regions were again in expansion during November and this has been the case for three consecutive months. In the North Island, the *Northern* region (62.0) continued its upward momentum to record its highest value since November 2013, while the *Central* region (52.8) experienced a lower level of expansion by comparison with October. In the South Island, the *Canterbury/Westland* region (63.7) recorded its highest value since May 2013, although the *Otago-Southland* region (62.7) came back from its strong result for the previous month.

Manufacturing by industry sub-groups was again almost all positive during November. *Petroleum, coal, chemical & associated product manufacturing* (66.7) remained strong, despite a drop from consecutive post-70 point values. *Machinery & equipment manufacturing* (58.3) also experienced a slight fall in expansion, while *metal product manufacturing* (55.7) fell 2.6 points from the previous month.

Globally, the JPMorgan Global Manufacturing PMI for November (51.8) was the lowest in 14 months.

Meanwhile the seasonally-adjusted BNZ – BusinessNZ Performance of Services Index (PSI) is also showing solid expansion with the PSI for November standing at 54.8. While this result was down 2.2 points from October, the PSI has shown solid expansion through 2014, averaging 56.5.



Despite a dip in levels, for the sixth month running all five main sub-indices were in expansion. *New orders/business* (56.4) led the way in November, although at its lowest level since February this year. This was followed by *activity/sales* (55.7), which also dropped below the 60-point level of expansion. *Stocks/inventories* (53.3) increased from October, as did *employment* (53.2). *Supplier deliveries* (52.8) decreased 0.3 points.

Activity remained positive throughout the country, although again there was some movement compared with the previous month. In the North Island, the *Northern* region (55.5) dropped 3.6 points to record its lowest result since June this year, while the *Central* region (57.1) returned to the level previously seen in September. In the South Island, the *Canterbury/Westland* region (56.8) fell slightly from the previous month and the *Otago/Southland* region (65.3) did likewise.

Service sector results by sub-sector were mostly in expansion during November. *Property & business services* (60.2) experienced a sharp upswing by comparison to October, while *wholesale trade* (58.4) came back from a very strong result during the previous month. *Health & community services* (50.0) edged up slightly to no change for November.

Internationally, the JPMorgan Global Services PSI for November (53.5) represented a seven-month low in global activity.

Consumer confidence – guarded optimism

Consumer confidence is still firmly in positive territory and recent surveys suggest that it is holding its own – largely on the back of an improving labour market. After taking a hit over much of 2014, confidence has increased on the back of clear signs that interest rate rises will be on hold for an extended period of time. High levels of household debt are still an Achilles heel for consumer confidence with increasing housing prices a two-edged sword. Increasing prices encourage households to borrow more, perhaps beyond their means. On the other hand, increasing prices often encourage individuals to open their wallets to more discretionary items on the assumption that an increased price will give them more 'paper' equity in their homes.

The ANZ-Roy Morgan NZ Consumer Confidence lifted from 121.8 in November to 126.5 in December, well above the long-term average.

The ANZ identified 5 key issues as driving improved consumer confidence:

- House prices firming again. A pre-election lull has been replaced by a post-election bounce
- Mortgage rates falling
- Petrol prices coming down, delivering an effective pay rise
- Employment prospects remaining strong
- Inflation low and deflation ruling in some pockets. Price competition in retailing is aggressive with power residing with the consumer

1.4 Labour market – from strength to strength

Employment – growth continues

Employment growth is still relatively strong with associated reductions in unemployment as outlined below. The unemployment rate is expected to reach 4.9 percent by December 2014.

Forecasts: Unemployment % (HLFS)

	Quarter		
	Dec 14	Dec 15	Dec 16
Highest	5.4	5.4	5.9
Average	5.4	5.1	4.9
Lowest	5.2	4.9	4.3

Source: ANZ, ASB, BNZ, and Westpac

The BNZ - BusinessNZ PMI and PSI surveys show solid growth in employment outcomes, both in the manufacturing and the services sectors. Other business confidence surveys also indicate strong employment growth prospects, particularly in the construction sector. The BNZ-BusinessNZ PMI *Employment* sub-index sat at 54.9 for the month of November 2014. Meanwhile the PSI *Employment* sub-index sat at 53.2,

The level of expansion in employment has been relatively consistent throughout 2014 both for the PMI and PSI, as can be seen below. This is consistent with a number of other survey data (both official and unofficial) which show relatively strong employment growth and an associated reduction in unemployment.

Seasonally adjusted Time Series for Employment Outcomes (PMI and PSI)

Month	PMI Employment	PSI Employment
Jan 14	50.7	54.6
Feb 14	54.6	53.2
Mar 14	55.9	54.1
Apr 14	53.6	53.1
May 14	53.1	52.5
Jun 14	52.8	52.8
Jul 14	51.7	54.3
Aug14	54.3	55.7
Sep14	56.1	54.8
Oct 14	57.2	52.8
Nov 14	54.9	53.2

Source: BusinessNZ

While overall employment growth is relatively strong, average rates of employment growth tend to mask what is happening with unemployment rates in particular regions. While Christchurch is leading the charge with strong employment growth and an unemployment rate of just over 2% (arguably a rate that is less than the accepted rate of full employment when taking frictional and structural unemployment into the picture), other regions are not doing so well.

This perhaps emphasises the need to look specifically at the factors (both demand and supply) which are affecting the ability of some regions to succeed economically and perhaps the desirability of encouraging the relocation of resources (capital and labour) to where longer-term prospects appear better. The use of “relocation allowances” is part of a package approach to ensuring individuals can be successfully integrated into a different workforce and are able to improve their standard of living over time. Obviously a “one size fits all” approach is unlikely to be helpful and a range of measures is required to make a sizable dent, particularly in youth unemployment.

Labour costs – relatively benign

Forecasts below indicate that labour costs are expected to increase only slowly to around 2.2 percent for the year ending December 2015 and 2.3 percent for the year ending December 2016. These forecasts largely reflect a pick-up in labour market outcomes over the medium term.

Private sector salary and wage rates (including overtime) increased 1.8 percent in the year to the June 2014 quarter. Public sector salary and wage rates (including overtime) increased 1.2 percent in the year to the June 2014 quarter.

Forecasts: Labour cost index percentage change (wages & salaries)

	Years ending		
	Dec 14	Dec 15	Dec 16
Highest	1.8	2.3	2.5
Average	1.7	2.2	2.3
Lowest	1.7	2.1	2.1

Source: ANZ, ASB, BNZ, and Westpac

There will likely be some upward wage pressure over the coming year as labour resources are increasingly constrained, although there is little evidence of any significant upward pressure at this stage. Labour market pressures are largely confined to specific sectors and regions e.g. Auckland and Christchurch in respect to housing and construction.